

# *Institutional Environment and MNEs' Strategy in Transitional China*

Yongqiang Gao

MNEs face a complex institutional environment when doing business in the international market. As a result, MNEs adopt strategies to deal with the institutional pressures. However, present studies seldom discuss the institutional environment of a given country, specifically China. Therefore, the strategies that MNEs can use to cope with the institutions in China are far from being discussed. This study contributes to making up this gap. In this study, the identified important institutions in China are Chinese culture, governmental system, and non-governmental organizations (NGOs). They exert coercive and normative pressures on the operations of MNEs. Four strategies can be selected by MNEs to deal with the institutional pressures: guanxi strategy, commitment strategy, competitive strategy and leverage strategy. Guanxi strategy and commitment strategy are commonly used to build good guanxi with Chinese governors and NGOs. Competitive strategy is used when MNEs have high bargaining power against Chinese governments, while leverage strategy is used MNEs in setting conflicts between different institutions or parties to resist the unfavorable pressures from institutions in China.

*Key Words:* China, institutional theory, institutional environment/pressure, multinational enterprise (MNE)

*JEL Classification:* F23

## **Introduction**

Since the openness policy in 1978, China has attracted more and more FDI (foreign direct investment) from all over the world. Rapid economic growth, big market opportunity, and inexhaustible cheap high-quality labor forces have turned China into a paradise of investment. From 2004 on, China receives more than USD 60 billion every year. By 2000, 400 of the 500 most famous MNCs (multinational corporations) had invested in China (Luo 2000). After accession into WTO in 2001, the FDI that flows into China is again accelerated.

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However, after entering into China, MNEs find they confront a very different business environment from their home countries. The business settings in China are different from those in advanced Western countries in many ways. The most salient difference lies in its authoritarian political system, which exerts great influence on business operations and corporations' development (Chen 2004).

Although China is leading a transition of the economic system from a central planning economy into a market-oriented one, government influence is however still overwhelming (Child and Tse 2001). Despite two decades of reforms, officials at various levels of the government in China still have considerable power to approve projects and allocate resources (Walder 1995). As a result, arbitrary intervention from the government remains a constant danger to many firms (Nee 1992; Peng 1997). Therefore, an appreciation of Chinese business management will not be complete unless we carefully examine the complex interactions between businesses and governmental agencies. Successful investing in China requires investors to master a complex political and regulatory environment. Top managers make their important decisions after taking into consideration not only market factors such as customers, competitors and demand, but also the important roles played by various government entities in China (Li and Zhou 2005).

Regretfully, the political environment in China is seldom discussed in academia except for Chinese *guanxi* (Hwang 1987; Xin and Pearce 1996; Yang 1994; Yeung and Tung 1996). Besides, MNEs' strategies and behaviors dealing with the governments in China are far from being discussed either. This paper aims to make up the deficiency by focusing on the interaction between MNEs and the Chinese government.

This paper is organized as follows. The following section briefly reviews the FDI and MNEs received by China in recent years. Then we introduce institutional theory as the theoretical background. The fourth section discusses the political or institutional environment that MNEs have confronted in contemporary China. The fifth section analyzes the MNEs' response to the Chinese political environment. Finally, a conclusion is proposed.

### **FDI and MNEs in China: A Brief Review**

The inflow of FDI or foreign MNEs into China begins from the implementation of the openness policy in 1978. Records documented that, during the 1980s, FDI flows into China increased slowly. But two important

events accelerate the inflow of FDI into China thereafter. One event took place in 1992. In this year, Deng Xiaoping, Chairman of the State at that time, visited southern regions and published 'South Talk'. 'South Talk' ended the uptight disputation 'whether market economy is socialistic or capitalistic' in China, and as a result, most provinces formulated favorable policies to attract FDI and MNEs. Data show that in 1991, the actually used FDI in China is only USD 4.37 billion. But in 1992, the amount arrives at USD 11.01 billion, and to 1993, it even amounts to USD 27.52 billion. The second event takes place in 2001. In this year, China joined in WTO formally, which accelerated the inflow of FDI once again. The number of actually used FDI increased from USD 40.72 billion in 2000 to USD 52.74 billion in 2002. The effect of these two events on the inflow of FDI into China can be seen clearly in figure 1.

Figure 1 illustrates the achievement in using FDI that China achieved in the past two dozen years. In 1983, the FDI that China really used is less than USD 1 billion, but in 2005, China received more than USD 60 billion, which is more than sixty times the number of 1983. In 1991, the FDI that China received only accounts for 2.26 per cent of the global total FDI inflow. But in 2004, the FDI that China received accounts for 9.90 per cent of the global total FDI inflow (United Nations Conference on Trade and Development 2004). Today, China is the largest FDI destination among developing countries and the second largest in the world, following the US.

It is said that the success of China in receiving FDI may be attributed largely to the exhaustible cheap labor forces. But in recent years, the rapid growth of GDP acts as another contributor. With the accompanying increase in people's income, China is becoming a huge market for most commodities and services. For most MNEs, China is a market that they cannot lose.

There are five types of FDI approved by the foreign direct investment policy in China: (1) equity joint ventures, (2) contractual joint ventures, (3) foreign-funded enterprises (so-called WFOEs), (4) share-holding enterprises, and (5) cooperating development (Chen 2004). By the end of June 1997, it was reported that over 200,000 business joint ventures had been registered in China, with a total foreign investment of USD 204 billion (*China Statistics Yearbook* 1997).

In 2000, as many as 400 of the 500 most famous MNCs had made investment in China (Luo 2000). Today, it is said that more than 450 of Fortune 500 companies (listed in year 2004) invest in China. The amount

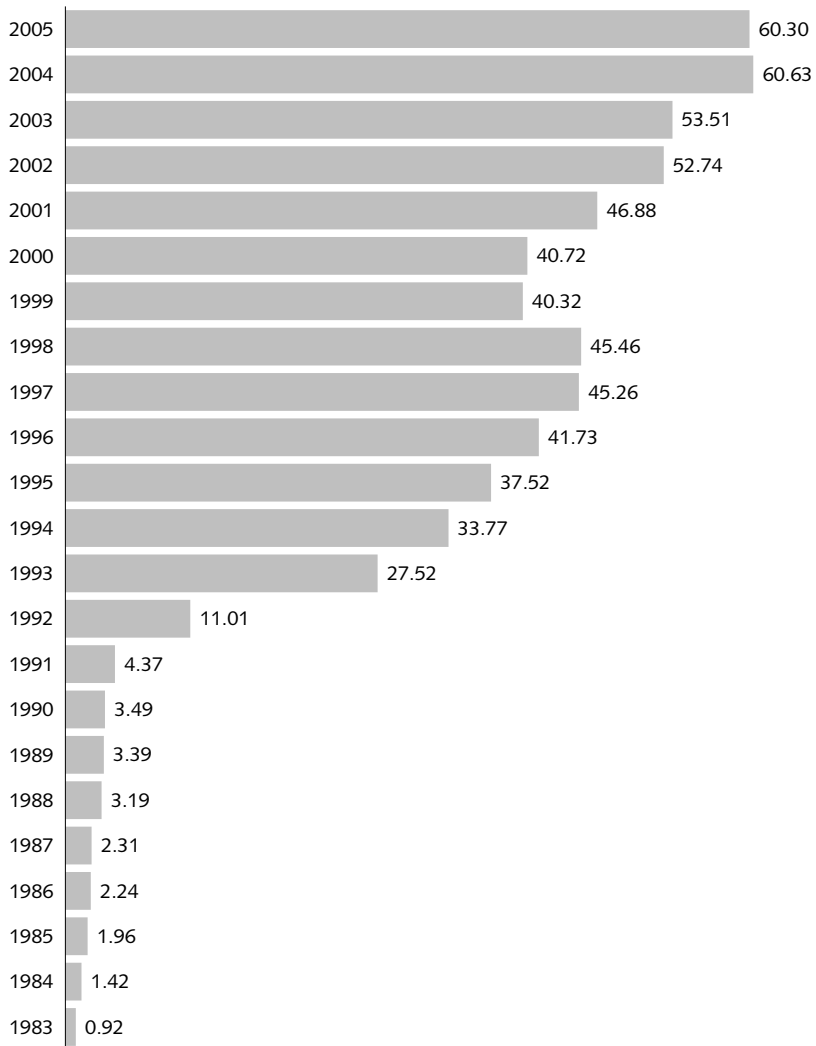


FIGURE 1 FDI inflow into China (in billion US dollars, drawn from the *China Statistics Yearbook* (see <http://www.stats.gov.cn>) for corresponding years)

of MNEs that make investment in China totals 280 thousand, and the actual used foreign capital amounts to USD 600 billion (*China Statistics Yearbook* 2005).

### **Theoretical Background: Institutional Theory**

Businesses respond to their environment either to develop and exploit opportunities or to react to perceived threats (Andrews 1987). Chan-

dler (1962) was an early contributor to a long tradition of research on the relationship between environment and strategic behaviour. He suggested that changes in strategy, and in structure, are directly related to changes in the market or in general in the firm - relevant environment. His work has opened the door to the important contingency theory contributions and to a flurry of theories and studies that have confirmed the close relationships between environment, strategy and structure (Lawrence and Lorsch 1967; Thompson 1967; Venkatraman and Prescott 1990).

Different from the contingency theory that focuses mostly on the task environment (Thompson 1967), institutional theory deals with choices made in response to or in compliance with an organization's institutional environment (Bluedorn et al., 1994). Institutional theory, which developed from the behavioural theory of the firm, focuses on the purposeful efforts of individuals to respond to environmental pressures in ways consistent with the institution's rituals and formality and based on values that are important to the institution (Stinchcombe 1997).

Institutions are defined as regulatory structures, governmental agencies, laws, courts, and professions (Scott 1987a, 498). They 'define conditions and set limits for maintaining a stable system; they regulate social relations to maintain conformity with existing value patterns and consistency among these patterns themselves' (Oberman 1993, 215).

The institutional environment comprises the rules and requirements with which organizations must comply to gain the desired rewards of support and legitimacy (DiMaggio and Powell 1983; Meyer and Rowan 1977; Zucker 1988). Institutional theory identifies three types of pressure: coercive-conforming in response to unavoidable requirements, such as regulatory pressure, normative-conforming in response to cultural norms, and mimetic-conforming to meet (mimic) the behaviors of competitors (DiMaggio and Powell 1983).

Institutionalists emphasize that rules, laws and regulations, norms of behaviour, and cultural-cognitive orientations all but determine behaviour more than do contingency and competitive factors (DiMaggio and Powell 1983). Institutional actors include not only the state and the professions, but also interest groups and public opinion (Scott 1987b).

In the search for legitimacy and acceptance, organizations tend to behave in ways that are alike rather than different. Isomorphic behaviour is

therefore seen as widespread, conditioning even strategic behaviour. It is considered essential for organizational success in a complex institutional environment.

In this study, the main institutions that MNEs face in China include unique Chinese culture, the governmental system and non-governmental organizations (NGOs). The corresponding institutional pressures that MNEs confront include coercive pressure from government policies and regulations and normative pressures from Chinese culture and NGOs. MNEs have to develop strategies to deal with the pressures.

### **The Institutional Environment in China**

The typical institutions that MNEs have to cope with are Chinese culture, governmental system and NGOs. The characteristics of these institutions are introduced in this section.

#### **THE CONFUCIANISM CULTURE**

Chinese traditional culture is also called Confucianism, due to the influence of Chinese sage Confucius (ca. 551–479 BC). Confucianism is not a religion but a set of guidelines for proper behavior (Hofstede 1991; Tu 1998b). Confucianism has shaped the social interaction of people in eastern and southeastern Asian countries for more than 2000 years (De Bary 1991; Slote and DeVos 1998; Tu 1998a; 1998b). Recent economic miracles in Hong Kong, Singapore, Taiwan, and other southeastern Asian countries have aroused interest in Confucianism (Yan and Sorenson 2006).

The most outstanding characteristic of Confucianism culture is *guanxi* (relationship). Confucianism considers people as a part of the social network. The whole society is just a huge network in which a person plays different roles. In general, Confucianism uses five virtues to define the relationship between individuals (Tu 1998a). The five virtues are humanity/benevolence (*ren*), righteousness (*yi*), propriety (*li*), wisdom (*zhi*), and trustworthiness (*xin*). Five basic social relationships are also defined: father and son, ruler and ruled, husband and wife, elder brother younger brother, and friend and friend (Tu 1998c; Xing 1995).

As a result of Confucianism culture, the legal system of China is relatively weak, while ‘*guanxi*’ among individuals is very strong. It is well known that the Chinese are enthusiastic in building *guanxi* with others. Business often takes place between two parties that are connected with each other. The importance of *guanxi* in China is well recognized

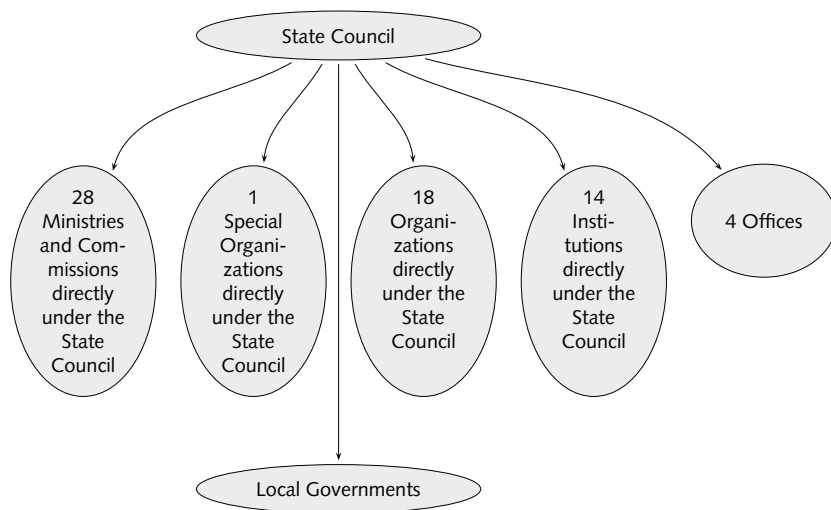


FIGURE 2 The Structure of Chinese Governments (adapted from *Bulletin of State Council*, 30 April 2003)

by many scholars (Leung and Yeung 1995; Tsang 1998; Xin and Pearce 1996).

Culture as an institution exerts normative pressure on MNEs, which requires MNEs to recognize the cultural differences between home and host country and respect the host country's culture. Business operations should comply with the norms and values embedded in the host culture.

#### THE GOVERNMENTAL SYSTEM

The governments in China can generally be divided into two levels: the central government and the local governments. The central government includes the State Council and its directly controlled organizations. Local government can further be divided into provincial, municipal, county and township governments. The structure of Chinese government institutions is illustrated in figure 2.

Many organizations are authorized by State Council to formulate policies and regulations aiming at MNEs. For instance, the National Development and Reform Commission (NDRC) is authorized to issue the 'Catalogue for the Guidance of Foreign Investment Industries', and the State Administration of Taxation (SAT) is authorized to formulate preferential tax policies about FDI, and the like.

As far as business is concerned, Chinese governments show the following characteristics:

1. Extensive government intervention in economic affairs. It is said that in the 1990s, to get government approval, a typical major construction project experienced checks by 7 ministries, 8 examining and approval bureaux, and had 58 red stamps and 169 officials' signatures, and this process lasted two years (Tian et al. forthcoming). After the implementation of 'Administrative Approval Law', there are still 500 items/projects need to be approved by the related government agencies. Procedures to acquire official approval are very time-consuming (Holtbrugge and Berg 2004) and costly.
2. China is a country with a decentralized government structure. National laws are often only broadly drafted at the central level and their implementation is left to the discretion of regional and local administrations (Holtbrugge and Berg 2004). The decentralized government structure gives provincial and local governments the freedom to intervene in economic activities. 'In this context any prominent administrator is in a position to give a go-ahead to an exception and can find out a suitable reason for it, such as to relieve rural poverty, to reduce losses incurred by a state-owned firm, or to defuse disturbances among a group of employees' (Blackman 2000).
3. There are conflicts among different administrators. Firstly, since local governments face different primary interests from the central government, it is inevitable that there is conflict between local governments and the central government. Conflict among different levels of authority arises for the following reasons: (a) inconsistent interpretations of laws and regulations, (b) different political priorities of economic issues, and (c) various stakes acquired from MNEs (Chen 2004). Besides, the division of jurisdiction among different ministries is not very clear in China. As a result, different ministries often issue conflicting regulations.

Government acts as a coercive pressure on MNEs. MNEs are not only demanded to abide by the policies and regulations issued by government, but also to meet the expectations of government, such as large scale of investment, transferring high technologies or management skill, and so on.



#### THE NGOS

The rising influence of non-governmental organizations (NGOs) is one of the most significant developments in international affairs over the past 20 years. The emergence of NGOs seeking to promote more ethical and socially responsible business practices is beginning to cause substantial changes in corporate management, strategy, and governance (Doh and Teegen 2003).

There are about 800,000 NGOs in China, including media, charities such as China Charity Federation (CCF), China Welfare Fund for the Handicapped (CWFH), China Foundation for Poverty Alleviation (CFPA) and China Youth Development Foundation (CYDF), trade unions, and other NGOs such as All-China Association of Industry and Commerce (ACAIC), All-China Women's Federation (ACWF), All-China Federation of Trade Unions (ACFTU) and All-China Youth Federation (ACYF), etc.

Among the NGOs, the media play an outstanding and increasingly important role. They can lead public opinion, which in turn imposes on business operations. However, the media and other NGOs are controlled by the governments in China. Although the media can comment on and criticize the misconduct of businesses or even governments, the underlying rule is that if a conduct or business is approved by the governments, the media within the jurisdiction of the governments should not say 'no' (Gao 2007). To understand this point is critical for businesses dealing with NGOs in China.

NGOs bring normative pressure to bear on MNEs. MNEs are expected to do business in China ethically. They are also expected by the NGOs to give a helping hand in settling down laid-off workforce, providing charitable donations, improving the community's medical and sanitary conditions, and the like (Gao 2007).

#### **MNEs' Strategies towards the Institutional Environment**

Facing institutional pressures, some firms adapt themselves to the pressures passively, while more firms respond to the pressures proactively, by taking into account both their resources and the strength of the institutions involved. Oliver (1991) has suggested five strategies that could be used by MNEs: acquiescence, compromise, avoidance, defiance, and manipulation. Although the typology of Oliver (1991) is widely used in

academia, here we would like to provide another typology. We think if MNEs want to strive for a favourable institutional environment or to deal with the unfavourable institutional pressures in China, four strategies are recommended: guanxi strategy, commitment strategy, competitive strategy and leverage strategy.

#### GUANXI (RELATIONSHIP) STRATEGY

Confucianism culture indicates that a guanxi strategy is the most important strategy for doing business in China. Guanxi generally refers to relationships or social connections based on mutual interests and benefits (Yang 1994). It is a way for MNEs to adapt to the institutional environment and to obtain scarce resources such as legitimacy and approval in China.

How to build social and business guanxi in China is the core problem for MNEs. Present literature on guanxi has shed light on the ways to build guanxi in China (Fock and Woo 1998; Pearce and Robinson 2000; Yeung and Tung, 1996). Put simply, as Gao and Tian (2006) and others identified, the frequently used ways to build guanxi with Chinese government officials are gift-giving and money-giving, inviteing officials to banquet, visiting officials frequently, paid travel, honoraria for speaking, inviteing officials to inspect workshops, personal help, and so on.

The main difficulty in adopting a guanxi strategy lies in its ethics. To build guanxi often means to give a gift, as Yeung and Tung (1996) identified, gift giving is one of approaches to build a guanxi (relationship) in China. Although formal gift-giving is different from bribery in China (Steidlmeier 1999), it is very difficult to identify an ethical gift-giving from an unethical gift-giving or bribery. Just as Steidlmeier (1999) noted, 'from an ethical perspective, it is very difficult to know when it is proper to give or receive a gift, what sort of gift is appropriate, or what social obligations gift giving imposes.' Therefore, MNEs should be careful in adopting a guanxi strategy.

#### COMMITMENT STRATEGY

Commitment can be taken as a tool to build good relationships between MNEs and the Chinese governments. However, as we discussed previously, since Chinese governments and NGOs have expectations regarding MNEs, the latter can meet the expectations by 'commitment'. Commitment strategy can help MNEs to build a favorable institutional environment even though they do not have guanxi with governmental officials.

Hung's study (2002) of MNCs in China showed that, after 20 years of economic development, commitment is still the strongest element for demonstrating multinationals' determination to do business in China and an incentive to gain the support of the Chinese government. MNEs have demonstrated four ways of showing their commitment to the Chinese authorities. The first is to increase their investments in China. The second is to use their advanced technologies and management techniques for the betterment of Chinese society, and the third is to devote themselves to communities and social affairs, such as donations and participating in the Project of Hope for poor children's education in the rural areas. The last approach is to localize multinationals' practices in China by hiring and training Chinese employees (Chen 2004).

#### COMPETITIVE STRATEGY

When an MNE has high bargaining power against Chinese governments due to its substantive capital and advanced technologies, it can adopt a competitive strategy. A competitive strategy means that MNEs can bargain with the Chinese government. It can be seen as an action taken by MNEs to reduce institutional uncertainty and ensure the resource supply in China.

To take a competitive strategy, the first step is to identify and evaluate the bargaining power of MNEs against the Chinese government. If an MNE's bargaining power is low, then a coalition may be built or the collective organizations such as Chamber of Commerce are utilized.

A good example is the coalition of 54 foreign companies in China to bargain with the State Council of China. When they heard that the Chinese government wants to integrate income tax for domestic and foreign companies (foreign companies enjoy revenue alleviation in China since 1978, the income tax rate for domestic firms is 33%, while for foreign companies it is 15%) and to increase the income tax rate of foreign companies in 2004, 54 foreign companies built a temporary coalition. The coalition formulated a report named 'Some opinions on the new income tax law for enterprises from foreign companies in China' and, in January 2005, sent it to the Legal System Office of State Council of China, Ministry of Finance, Ministry of Commerce and State Administration of Taxation. The report requests the Chinese government to give a 5–10 year transitional period and hopes that the Chinese government will provide a 'reasonable and competitive' income tax rate for MNEs. The collective action of foreign companies obstructs successfully

the integration of income tax for domestic and foreign companies (Gao 2008).

Beside the contemporary coalitions, some permanent coalition of MNEs have emerged in China, for example, the US Chamber of Commerce and European Chamber of Commerce.

#### LEVERAGE STRATEGY

Leverage strategy refers to using one part to beat another part. MNEs have three ways to take a leverage strategy. The first is making use of the local government to resist the influence of central government, or one Ministry to beat another. The second is making use of home government in bargaining with the Chinese government. The third is making use of international institutions such as WTO to resist the Chinese government (Gao 2008).

At first, China is a country with a decentralized government structure (Holtbrugge and Berg 2004). The decentralized government structure gives local governments the freedom to intervene in economic activities to some extent. Since local governments face different primary interests from the central government, it is inevitable that there is conflict between local governments and the central government. Conflict among different levels of authority arises for the following reasons: (1) inconsistent interpretations of laws and regulations, (2) different political priorities of economic issues, and (3) various stakes acquired from MNEs (Chen 2004). In addition, the division of jurisdiction among different Ministries is not very clear in China. As a result, different Ministries often issue conflicting regulations. As a consequence, many MNEs influence Chinese business policies toward their preferred directions by gaining support from their governmental partners or by leveraging one governmental unit against another. For example, the Tianjin Technological and Industrial Development Zone Authority (TIDZA) completely supported its biggest client, Motorola China, and challenged Beijing in a number of regulations to assist Motorola in becoming a member of the zone (Post et al. 2002).

Secondly, some MNEs ask home government for help in bargaining with the Chinese government. Through negotiations of bilateral agreements, MNEs are empowered to affect Chinese policies or regulations as a whole nation. This gives MNEs more power by changing the political structure wherein negotiations take place from state-to-state rather than state-to-firms. In addition, putting the business issues at an international

level allows foreign firms with hegemonic states as home countries to affect China's decisions through the operation of international organizations (Chen 2004). Amway China applied this strategy when dealing with the Chinese ban on direct selling in 1998.

Thirdly, after China joined the WTO in 2001, some MNEs begin to use the rules of WTO to influence the decision-making of the Chinese government. Petras (2000) argued that China's integration into global markets through WTO membership produces a greater subordination to the USA, based on its aggressive economic, military and political power inherent in the international system. He argued that by further lowering barriers of foreign business operation and trade as required by the WTO, the USA gains strategic advantages and US-based MNEs obtain access to China's financial sector, agricultural market and high-tech consumers. Pearson's analysis (2000) of China's accession to GATT/WTO found four significant driving forces in the formation of Chinese foreign trade policy: elite preference, pluralization of domestic actors, external influences and public opinion. As to the external influences, Pearson (2000) argued that international pressure originated from international leadership seeking to force China into an existing international market and system in order to be able to regulate and monitor its actions. She further pointed out that the most decisive international influence is to learn from norms and beliefs applied in international regimes.

### **Conclusion**

China, as a huge market and the supplier of exhaustible cheap qualified work forces in the world, has attracted more and more MNEs. However, China is a very different market from the West's due to her unique institutional environment. This paper acts as an endeavour to discuss the institutional environment, especially the political environment in China and the responses of MNEs.

The main institutions in China are Chinese culture, governmental system and NGOs. They exert either coercive pressure or normative pressure on MNEs. In dealing with the institutions, MNEs can take four strategies: *guanxi* strategy, commitment strategy, competitive strategy and leverage strategy. The *guanxi* strategy and commitment strategy aim at building good *guanxi* with governments. Competitive strategy is used when an MNE has bargaining power or can gather bargaining power by collection against the Chinese government. MNEs have three ways to take a leverage strategy: (1) Making use of the local government to resist the influence of

central government, or one Ministry to beat another; (2) Making use of home government in bargaining with the Chinese government; (3) Making use of international institutions such as WTO to resist the Chinese government.

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